
State Controller's Financial Overview

ECONOMIC OUTLOOK

California, the largest state in the U.S., both in population and in economic activity, is currently experiencing its best economic growth in five years. From 1990 through 1993, the State had a protracted economic downturn. That recession was associated with a sharp reduction in defense spending and a national recession in 1990-91. By the end of 1996, the State will have recovered all the employment lost during the recession and employment growth is expected to outperform the U.S. as a whole over the next three years. The lingering recession has meant that the unemployment rate in California is still the highest of the large industrial states (expected to average 7.9% for the current year) but the current recovery is expected to drop the unemployment rate to under 7% by the end of the decade.

Employment in California, as in the rest of the nation, is concentrated in services (27%). California has also been a manufacturing center, especially a high-technology manufacturing center. In 1990, 17% of California's work force was employed in manufacturing compared to 16% in the nation as a whole. This was closely related to the concentration of defense contractors in the State. The recession resulted in contractions of employment in the aerospace industry and the manufacturing related to that industry. In 1995, it is estimated that only 14% of the work force is employed in manufacturing. Even with the decline of the defense industry, however, California is continuing its role as a center of high technology. The technology is now concentrated in computers, electronics, communications and the emerging multi-media field. Many of these activities are classified as service sector jobs but are as hi-tech as the defense jobs they are replacing.

As noted, there was considerable contraction in aerospace related manufacturing during the recession. Significant reductions of employment were also seen in finance and real estate. These industries saw declines related to both restructuring (bank consolidations) and cyclical factors. As the economy recovers, the real estate industry is expected to rebound and should give an added boost to the pace and duration of the recovery.

California has, for a long period, been among the top 10 states in per capita personal income. By 1994, California ranked number 14 in per capita personal income among the 50 states. While the drop out of the top 10 states was due to the severity of the recent California recession, the gap between incomes in California and the rest of the nation has been diminishing for a longer period. In 1960, per capita income in California was 123.5% of the U.S. average. By 1994, California per capita income was 103% of the U.S. average. While the recent period has seen a dramatic slowing of income growth in California, over the longer period the closing of the gap in income is associated with rapidly rising incomes in the rest of the U.S., not because of a lack of growth in California. A final factor in explaining the trend has been that California has seen a sharp rise in birth rates

over the past decade, and a rise in household size, which tends to reduce per capita growth.

The largest increases in major state expenditures over the past decade have been in health and welfare. Health and welfare expenditures have increased by 129% since 1986, more than twice the rate of growth of tax revenue growth (62%). This has been associated with a 141% increase in intergovernmental transfers, primarily from the federal government for health and welfare programs. For that reason, intergovernmental transfers have grown from 23% of state spending in 1986 to 31% in 1995. If health and welfare expenditures are subtracted, then the rate of growth of state government expenditures (53%) has been lower than the rate of growth of tax revenue collections (62%) for the period 1986 to 1995.

As this is being written, California's current indicators show a trend towards an improved economy, including a recovery of major industries, expansion of product exports, an improved personal income growth rate and continued population growth. Among the industries that have led the economic growth during the recovery are business services and the entertainment industry. The entertainment industry, focused in Southern California, is expected to grow at twice the rate of the rest of the economy over the next three years.

Exports, cutting across many industries, have also grown rapidly over the past two years. Export growth was over 15% in 1994 and is expected to be equally strong in 1995. Much of this export activity is in computers, electronics, industrial machinery and entertainment. It is expected that these activities will continue to foster employment growth in California over the next several years.

With the renewed economic activity has come a much improved personal income growth. Personal income is expected to grow by 5.9% during the 1995-96 fiscal year. Revenue growth for the State is also reflecting the renewed economic activity. In the first seven months of the 1995-96 fiscal year, California's General Fund revenues are 10% higher than in the same seven months of the 1994-95 fiscal year.

Californian's Mediterranean climate and legendary "lifestyle" amenities have long made the State attractive to migrants from around the world. As a result, California's population growth has outpaced that of the nation for most of the past century. Thus, even though California is now experiencing relatively slow population growth (1.4% annual gain in 1995), it will continue to outpace population growth in the nation as a whole for the remainder of the decade. This population growth will also contribute to economic growth in California over the next few years.

MAJOR INITIATIVES FOR THE YEAR

The 1994-95 fiscal year represented the fourth consecutive year the Governor and Legislature were faced with a very difficult budget environment to produce a balanced budget. The Governor's Budget Proposal, as updated in May and June 1994, recognized that the accumulated deficit could not be repaid in one year, and proposed a two-year solution designed to eliminate the accumulated budget deficit, estimated at \$1.8 billion on June 30, 1994, by June 30, 1996.

The 1994-95 Budget Act, signed by the Governor on July 8, 1994, projected General Fund revenues and transfers of \$41.9 billion, \$2.1

billion more than actual revenues received in 1993-94, and expenditures of \$40.9 billion, an increase of \$1.6 billion from the prior year. The revenue estimates partly reflected the administration's forecast of an improving economy. The principal features of the 1994-95 Budget Act were the following:

1. Receipt of additional federal aid of about \$760 million for costs of refugee assistance and costs of incarceration and medical care for illegal immigrants. The Department of Finance estimated that about \$33 million of these funds were received during the State's 1994-95 fiscal year.
2. Reductions of approximately \$1.1 billion in health and welfare costs. Certain of these actions have been blocked so far by legal challenges.
3. A General Fund increase of approximately \$38 million in support for the University of California and \$65 million for the California State University, accompanied by student fee increases for both the University of California and California State University.
4. An increase of Proposition 98 funding for kindergarten through twelfth grade schools and community colleges by \$526 million from 1993-94 fiscal year levels, representing an increase for enrollment growth and inflation. Consistent with previous budget agreements, Proposition 98 funding provided approximately \$4,217 per student for kindergarten through twelfth grade schools and community colleges, equal to the level in the prior three years.
5. Additional miscellaneous cuts (\$500 million), fund transfers (\$225 million), and adjustment to prior years' legislation concerning property tax shifts for local governments (\$300 million).

The 1994-95 Budget Act contained no tax increases. Under legislation enacted in conjunction with the 1993-94 Budget Act, the renters' tax credit was suspended for two years (1993 and 1994). A ballot proposition to permanently restore the renters' tax credit after this year failed at the June 1994 election. The Legislature enacted a further one-year suspension of the renters' tax credit for 1995, saving about \$390 million in the 1995-96 fiscal year.

The 1994-95 Budget Act assumed that the State would use a cash flow borrowing program in 1994-95 which combined one-year notes and two-year warrants, which were issued in the summer of 1994. Issuance of the warrants allowed the State to defer repayment of approximately \$1.0 billion of its accumulated budget deficit into the 1995-96 fiscal year. No automatic spending cuts were required under the Budget Adjustment Law.

Reports by the Department of Finance in May 1995, indicate that, with economic recovery well underway in the State, General Fund revenues for the entire 1994-95 fiscal year were above projections, and expenditures were below projections because of slower than anticipated health/welfare case load growth and school enrollments. The aggregate effect improved the budget picture by about \$500 million, leaving an estimated budget deficit of about \$630 million June 30, 1995.

FINANCIAL INFORMATION

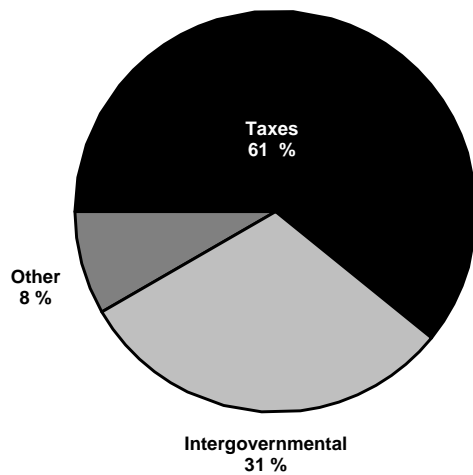
The government provides a full range of services including education, health and social services, transportation, law, justice, public safety, recreation, resource development and public improvements.

The financial reporting entity of the State includes all the funds and account groups of the primary government as well as all of its component units. Component units are legally separate entities for which the primary government is financially accountable. Blended component units, although legally separate entities, are, in substance, part of the primary government's operations and are included as part of the primary government. Accordingly, the building authorities are reported within the capital projects funds of the primary government. The lease agreements, amounting to \$319 million between the building authorities and the State, have been eliminated from the combined balance sheet. Instead, only the underlying fixed assets and the debt used to acquire them are reported in the appropriated account groups. Discretely presented component units are reported in separate columns in the combining financial statements to emphasize that they are legally separate from the primary government and to differentiate their financial position, results of operations and cash flows from those of the primary government. The University of California and various Authorities are reported as discretely presented component units.

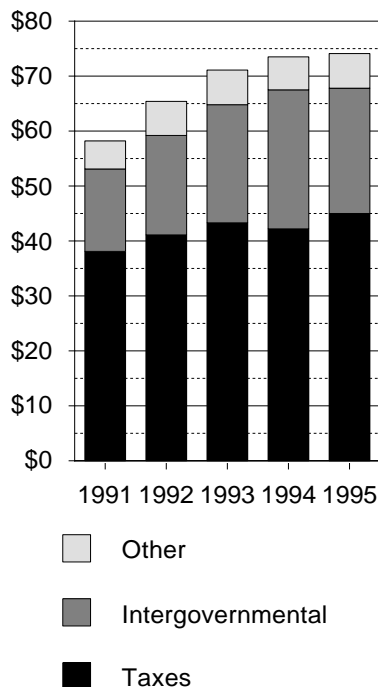
Annually the State Legislature prepares a budget that contains estimates of revenues and expenditures for the ensuing fiscal year. This budget is the result of negotiations between the Governor and State Legislature. Throughout the fiscal year, adjustments in the form of budget revisions, executive orders and financial legislation agreed to by the parties, are made to the budget. The Controller is statutorily responsible for maintaining control over revenues due the State and the expenditure of each appropriation contained in the budget. Budgeted appropriations are the expenditure authorizations that allow state agencies to purchase or create liabilities for goods and services.

The State's accounting system provides the Controller's Office with a centralized control record system to fully account for each budgeted appropriation, including its unexpended balance, and for all cash receipts and disbursements. The accounting system is decentralized in that the detail of each control account is maintained at the agency level. During the fiscal year, the control accounts and agency accounts are maintained and reconciled on a cash basis. At the end of the fiscal year, each agency prepares annual accrual reports for receivables and payables. The Controller's Office combines its control accounts with the agency accrual reports to prepare the budgetary basis financial report entitled the "State of California Annual Report." The methods of accounting for expenditures and revenues in that report are governed by State laws and regulations that, in some cases, are not in full agreement with generally accepted accounting principles. The State's Comprehensive Annual Financial Report represents a consolidation of the amounts in the "Annual Report" and adjustments to the account balances that conform to generally accepted accounting principles.

REVENUES 1995
General, Special Revenue and
Capital Projects Funds



**REVENUE
by SOURCE**
General, Special Revenue and
Capital Projects Funds
(In Billions)



The State has established an internal control structure designed to ensure that the assets of the government are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute assurance, that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived; and (2) the valuation of costs and benefits requires estimates and judgments by management. In addition, the government maintains extensive budgetary controls. The objective of these controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the Legislature.

1995 Revenues - Table 1 presents a summary of General Fund, special revenue funds and capital projects funds revenues for the year ended June 30, 1995. Revenues for the State's General Fund, special revenue funds and capital projects funds totaled \$74.2 billion for the fiscal year ended June 30, 1995, an increase of \$770 million or 1.0 percent over the previous year. The major components of this change were tax and intergovernmental revenues. Tax revenues increased \$2.7 billion or 6.5 percent over the previous year. A decline in federal program receipts accounted for the \$2.3 billion decrease in intergovernmental revenues, most of which is attributable to funds received under the medical assistance and social services programs.

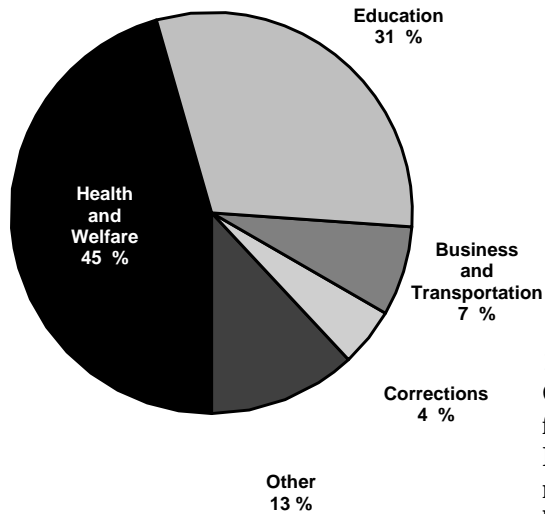
Table 1

Schedule of General Fund, Special Revenue Funds and Capital Projects Funds Revenues

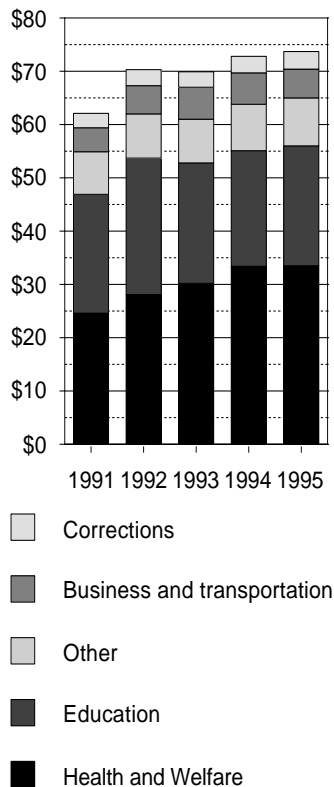
Year Ended June 30, 1995 (In Thousands)

Revenues	1995 Amount	Percent of Total	Increase (Decrease) from 1994	Percent of Increase (Decrease)
Taxes.....	\$ 44,940,196	60.5 %	\$ 2,730,225	6.5 %
Intergovernmental.....	22,933,080	30.9	(2,325,955)	(9.2)
Other major				
Licenses and permits..	2,832,516	3.8	107,386	3.9
Natural resources.....	69,888	0.1	24,910	55.4
Charges for services...	395,813	0.5	50,263	14.5
Fees.....	1,369,060	1.9	(66,661)	(4.6)
Penalties.....	485,237	0.7	98,730	25.5
Interest.....	538,659	0.7	219,686	68.9
Other minor.....	684,419	0.9	(68,816)	(9.1)
Total.....	\$ 74,248,868	100.0 %	\$ 769,768	1.0

EXPENDITURES 1995
General, Special Revenue and
Capital Projects Funds



EXPENDITURES by FUNCTION
General, Special Revenue and
Capital Projects Funds
(In Billions)



Five Year Trend - Total revenues for General Fund, special revenue funds and capital project funds have increased from \$58.2 billion in 1991 to \$74.2 billion in 1995, an increase of \$16.0 billion or 27.5 percent. This trend of increasing revenue is mainly attributable to an increase of intergovernmental transfers, which have increased from \$15.0 billion in 1991 to \$22.9 billion in 1995, an increase of \$7.9 billion or 52.7 percent. Revenues for the five year period increased \$1.5 billion, \$7.2 billion, \$5.7 billion, \$2.4 billion and \$.8 billion in fiscal years 1990-91, 1991-92, 1992-93, 1993-94 and 1994-95, respectively.

1995 Expenditures - Table 2 presents a summary of General Fund, special revenue funds and capital projects funds expenditures for the year ended June 30, 1995. Expenditures for the State's General Fund, special revenue funds and capital projects funds totaled \$74.2 billion for the fiscal year ended June 30, 1995, an increase of 1.9 percent or \$1.4 billion over 1994. Changes in expenditures by function from the last fiscal year levels are presented in Table 2. The majority of the 1994-95 change from the prior fiscal year is attributable to expenditures for education. Education expenditures increased by \$1.0 billion, which was primarily related to an increase in the average daily attendance.

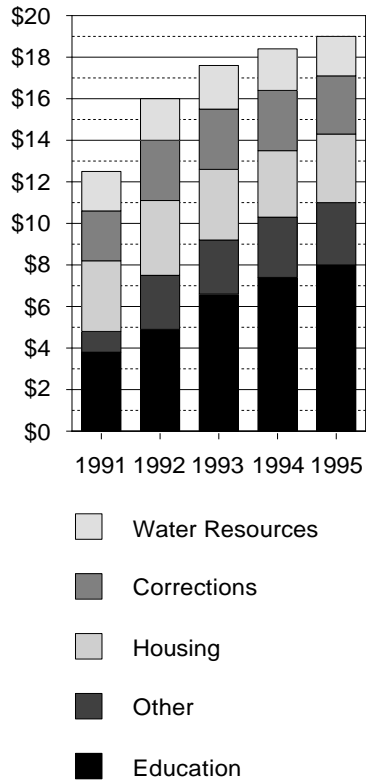
Table 2

Schedule of General Fund, Special Revenue Funds and Capital Projects Funds Revenues

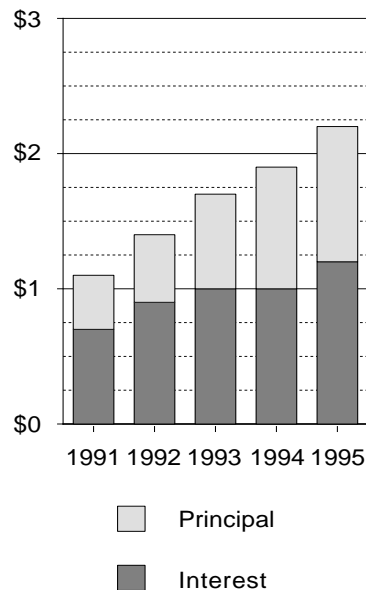
Year Ended June 30, 1995 (In Thousands)

Function	1995 Amount	Percent of Total	Increase (Decrease) from 1994	Percent of Increase (Decrease)
Health and welfare.....	\$ 33,335,716	44.9 %	\$ (21,009)	(0.1) %
Education.....	22,769,356	30.7	1,017,831	4.7
Business and transportation.....	5,499,433	7.4	(394,968)	(6.7)
Correctional programs.....	3,290,193	4.4	182,969	5.9
Other major				
General government.....	3,895,769	5.3	739,602	23.4
Resources.....	1,735,842	2.3	79,401	4.8
State and consumer services..	692,979	0.9	67,495	10.8
Property tax relief.....	475,610	0.6	10,935	2.4
Capital outlay.....	264,591	0.4	(680,176)	(72.0)
Debt service.....	2,257,153	3.1	372,801	19.8
Total.....	\$ 74,216,642	100.0 %	\$ 1,374,881	1.9

**GENERAL
OBLIGATION BONDS
by FUNCTION**
(In Billions)



**DEBT SERVICE
EXPENDITURES**
(In Billions)



Five Year Trend - Total expenditures for General Fund, special revenue fund and capital project funds have increased from \$62.1 billion in 1991 to \$74.2 billion in 1995, an increase of \$12.1 billion or 19.5 percent. This trend of increasing expenditures is mainly attributable to an increase of health and welfare expenditures, which have increased from \$24.6 billion in 1991 to \$33.3 billion in 1995, an increase of \$8.7 billion or 35.4 percent. In aggregate, expenditures for the five year period increased (decreased) \$2.7 billion, \$8.2 billion, (\$423) million, \$3.0 billion and \$1.4 billion in fiscal years 1990-91, 1991-92, 1992-93, 1993-94 and 1994-95, respectively.

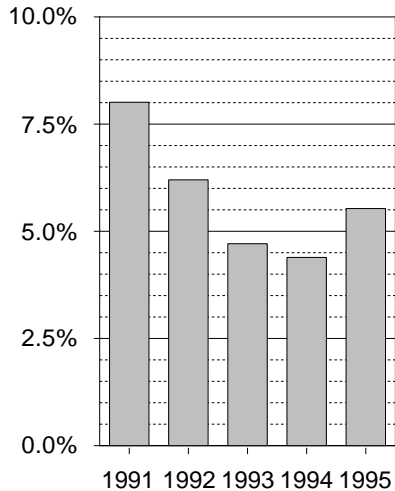
Debt Administration - On July 15, 1994, Standard and Poor's Ratings Group lowered its bond rating for California from "A+" to "A"; Fitch Investors Services lowered its rating from "AA" to "A"; and Moody's Investors Service lowered its rating from "Aa" to "A1".

General Obligation Bonds - General obligation bond debt, which is backed by the full faith and credit of the State, increased from \$18.4 billion on June 30, 1994 to \$19.1 billion on June 30, 1995, an increase of \$679 million or 3.7 percent.

Five Year Trend - Total outstanding general obligation bonds have increased from \$12.6 billion in 1991 to \$19.1 billion in 1995, an increase of \$6.5 billion or 51.6 percent. This trend of increasing bonded debt is mainly attributable to an increase in bonds for education purposes, which have increased from a cumulative balance of \$3.8 billion in 1991 to \$8.0 billion in 1995, an increase of \$4.2 billion or 110 percent. General obligation bonds outstanding for the five year period increased \$2.3 billion, \$3.4 billion, \$1.7 billion, \$.8 billion and \$.7 billion in fiscal years 1990-91, 1991-92, 1992-93, 1993-94 and 1994-95, respectively.

Debt Service - Principal retirement expenditures for the State's General Fund, special revenue funds and capital projects funds totaled \$954 million for the fiscal year ended June 30, 1995, an increase of \$80 million or 9.2 percent over the previous year. Interest and fiscal charge expenditures for these funds totaled \$1.3 billion for the fiscal year ended June 30, 1995, an increase of \$293 million or 29.0 percent over the previous year.

Five Year Trend - General Fund, special revenue funds and capital project funds principal retirement expenditures increased from \$388 million in 1991 to \$954 million in 1995, an increase of \$566 million or 146 percent. Interest and fiscal charges expenditures increased from \$1.1 billion in 1991 to \$1.3 billion in 1995, an increase of \$200 million or 18.2 percent.

PMIA YIELD

Cash Management Policies and Practices - Cash temporarily idle during the year was invested in the Pooled Money Investment Account (PMIA). The investment of the PMIA is restricted by law to the following categories: U.S. Government securities, securities of federally-sponsored agencies, domestic corporate bonds, interest-bearing time deposits in California banks and savings and loan associations, prime commercial paper, repurchase and reverse repurchase agreements, security loans, banker's acceptances, negotiable certificates of deposit and loans to various bond funds. The average daily investment balance for fiscal year 1994-95 amounted to \$26.8 billion with an average effective yield of 5.53 percent. For fiscal year 1993-94, the average daily investment was \$25.4 billion, and the average effective yield was 4.39 percent.

The Pooled Money Investment Board's 39th Annual Report for Fiscal Year 1994-95 disclosed that the total earnings of the PMIA in fiscal year 1994-95 amounted to \$1.5 billion. Of this amount, \$296 million was distributed to the General Fund, \$696 million to special funds, \$489 million to local governments, \$2 million to the Public Employees Retirement System, and \$2 million to the State Teachers Retirement System. The Pooled Money Investment Account Portfolio is shown in Table 3.

General Fund Balance - The State's General Fund ended fiscal year 1994-95 with a negative budgetary fund balance of \$394 million and a negative fund balance of \$1.1 billion using generally accepted accounting principles. The budgetary fund balance is made up of \$2.2 billion in reserves and a deficit of \$2.6 billion in the unreserved-undesignated portion of the fund balance. The reserves represent that portion of the fund balance not available for appropriation or that is legally set aside for specific uses. The unreserved-undesignated portion represents the amount available without restrictions to fund the subsequent year's budget. Because there was a deficit, no

carry-over funds from the fiscal year 1994-95 are available to finance the fiscal year 1995-96 budgetary plan. In addition, the general fund needs to increase \$2.6 billion before funds become available for use as previously designated.

The Special Fund for Economic Uncertainties (the "rainy day fund") was fully depleted, leaving a zero balance at the end of the fiscal year. Annually, an

Table 3**Pooled Money Investment Account Portfolio**

Fiscal Year 1994-95 (In Thousands)

Function	Average Daily Portfolio	Percent of Portfolio	Annual Earnings	Average Effective Yield
Money market.....	\$ 14,128,230	52.7 %	\$ 793,103	5.6 %
Government securities.....	11,573,526	43.2	620,172	5.4
Loans to other funds.....	341,325	1.3	17,152	5.0
Corporate bonds.....	1,286,303	4.8	76,986	6.0
Time deposits.....	217,522	0.8	12,218	5.6
Repurchase agreements.....	312,860	1.2	16,514	5.3
Reverse repurchase agreements..	(1,057,642)	(4.0)	(53,570)	5.1
Total.....	\$ 26,802,124	100.00 %	\$ 1,482,575	5.5

amount is appropriated in the General Fund to replenish the fund. This fund, as the name implies, is a "rainy day fund." It provides the funds for those necessary expenditures throughout the year that have not been anticipated or provided for in the annual budget. It also provides relief, to the amount of its available funds, for any budgeted revenue shortfalls. The Controller of the State of California is required to transfer to this fund the lesser of the following amounts: (1) the difference between the State's "appropriations subject to limitation" for the fiscal year that ended and its "appropriation limit" as defined in the Budget Act for that fiscal year, and (2) the unencumbered balance in the General Fund.

RISK MANAGEMENT

The State has elected, with a few exceptions, to be self-insured against loss or liability. The State generally does not maintain reserves. Losses are covered by appropriations in the year in which the payment occurs. Workers' compensation benefits for self-insured agencies are initially paid by the State Compensation Insurance Fund. The State Compensation Insurance Fund estimated the liability for future workers' compensation claims against the State's self-insured agencies to be approximately \$753 million as of June 30, 1995. The liability of \$94 million is being reported in the General Fund, \$62 million in special revenue funds, \$26 million in proprietary funds and \$571 million in the general long-term obligation account group.

INDEPENDENT AUDIT

State statutes require an annual audit of the general purpose financial statements of the State. To meet this requirement, the State Auditor has examined the accompanying financial statements in accordance with government auditing standards issued by the Comptroller General of the United States and generally accepted auditing standards. The auditor's report on the general purpose financial statements and combining and individual fund statements and schedules is included in this report.

The State of California is required to undergo an annual single audit in conformity with the provisions of the Single Audit Act of 1984 and the U.S. Office of Management and Budget's Circular A-128, *Audits of State and Local Governments*. Generally accepted auditing standards and the standards set forth in the General Accounting Office's Governmental Auditing Standards were used by the auditors in conducting the engagement. Information related to this single audit, including a schedule of federal financial assistance, the independent auditor's report on internal controls and compliance with applicable laws and regulations, and a schedule of findings and questioned costs are included in a separately issued single audit report.

ACKNOWLEDGEMENTS

The preparation of this report could not have been accomplished without the efficient and dedicated services of state agency accounting departments and the staff of the Controller's Division of Accounting and Reporting. We would like to express our appreciation to all those who contributed to the preparation of this report